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BASIC CONTRACT PRINCIPLES IMPACTING EXPLORATION PROJECTS

by

David E. Pierce
Professor of Law

Washburn University School of Law
Topeka, Kansas

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"[T]he movement of the progressive societies has hitherto been a movement from Status to Contract."¹

I. INTRODUCTION

"Exploration" is defined as "the investigation of unknown regions."² Contract law has always played a major role in managing the "unknown." The basic premise of American contract law is that parties can agree to order their affairs as they see fit, with minimal intervention by courts and legislatures.³ This remains the model, particularly when dealing with exploration projects where traditional give-and-take bargaining occurs among sophisticated parties. For example, in Nearburg v. Yates Petroleum Corp.,⁴ the New Mexico Court of Appeals refused to grant Yates a second chance to elect to participate in drilling a well when it failed to respond within the 30-day time frame set by

¹HENRY MAINE, ANCIENT LAW 170 (1861).
²WEBSTER’S NEW UNIVERSAL UNABRIDGED DICTIONARY 682 (1996).
³The Restatement (Second) of Contracts articulates the concept as follows:

The principle of freedom of contract is itself rooted in the notion that it is in the public interest to recognize that individuals have broad powers to order their own affairs by making legally enforceable promises.

the operating agreement. In reversing the trial court’s “equitable” approach to the issue, the Court of Appeals states: “A court should ... not interfere with the bargain reached by the parties unless the court concludes that the policy favoring freedom of contract ought to give way to one of the well-defined equitable exceptions, such as unconscionability, mistake, fraud, or illegality."

However, such “freedom” also means courts will be reluctant to rescue a party from what turns out to be a bad bargain. Freedom of contract creates both a “right” and the “obligation” to ensure it is used properly to accomplish your intended goals. The purpose of these Special Institutes on “Oil and Gas Agreements” is to assist those attending in using this freedom to accomplish your goals while minimizing unanticipated or unintended consequences of such freedom when defining your client’s destiny by contract.

II. CONTRACT FORMATION ISSUES

It is easy to create a contract. The absence of formalities means an enforceable agreement may arise before a party consciously realizes their actions have given rise to a contractual relationship. This is made possible by the American objective theory of contracts: what would a reasonable person be led to believe by the other party’s actions? Although the person making the statements or sending the letter may have subjectively intended not to make an “offer,” or exercise a “power of acceptance,” if that person’s objective (outward) manifestations indicate otherwise, such objective manifestations will control over the person’s true subjective intent. As with most rules of contract law, this creates...
a "burden" and an "opportunity." The burden occurs when a person fails to account for the rule and gives off objective messages not in accord with their subjective intentions. The opportunity is the ability to control the situation to ensure the person's "objective" message is consistent with their "subjective" intentions. This is what lawyers do, or should do, for their clients.

Controlling the formation of a contract involves making the parties' contractual status clear at all stages of a transaction leading up to the consummation of mutual assent. The critical task is distinguishing when the parties are engaging in "preliminary negotiations" leading up to the creation of a "power of acceptance," the "offer," or the exercise of a "power of acceptance," the "acceptance." The lawyer's role, and drafting task, is ensuring every party, at every stage of the contract formation process, can at any time answer the following two questions:

(1) Has a power of acceptance been created (is there an offer)?
(2) Has a power of acceptance been exercised (is there an acceptance)?

(b) each party knows or each party has reason to know the meaning attached by the other.

(2) The manifestations of the parties are operative in accordance with the meaning attached to them by one of the parties if:

(a) that party does not know of any different meaning attached by the other, and the other knows the meaning attached by the first party; or

(b) that party has no reason to know of any different meaning attached by the other, and the other has reason to know the meaning attached by the first party.

RESTATEMENT (SECOND) OF CONTRACTS § 20 (1981). The most common example of the varying subjective intent resulting in a lack of mutual assent is Raffles v. Wichelhaus, 2 Hurl & C 906 (Ct. of Exchequer 1864) (agreement to purchase cotton to arrive in Liverpool from Bombay aboard the ship "Peerless" and the evidence showed one party intended the Peerless sailing from Bombay in October and the other intended a different Peerless sailing from Bombay in December). An example of this principle being used in an oil and gas context is Sidwell Oil & Gas Co., Inc. v. Forbes, 630 P.2d 1107 (Kan. 1981), where the court found the landman intended the document to create a three-year paid-up lease but the landowner intended a three-year lease with delay rental payable on the first and second anniversaries of the lease. 630 P.2d at 1114 ("An offer of Loyd was made in terms that Lundy misunderstood; and Lundy accepted in terms that Loyd understood as an assent to the offer that Loyd meant to make."). The dissent contended the facts supported a claim of mistake that would justify reformation. 630 P.2d at 1115.

9Which is the creation of a "power of acceptance" in the other party.
Until there is a power of acceptance that has been exercised, the parties are engaged in preliminary negotiations which means, in most situations, they have no contractual restraints on their freedom of action. They can walk away without liability, or continue to negotiate in hopes of creating, and exercising, a power of acceptance.

The analysis is simply determining whether the activity constitutes preliminary negotiations or rises to the level of an event, either offer or acceptance, which has the potential to limit a party’s freedom of action. Each party has it within their power to minimize doubt about their status as preliminary negotiator, offeror, or acceptor.

A. Effectively Controlling the Creation of a Power of Acceptance

1. Offer or Preliminary Negotiations?

The challenge is to distinguish manifestations that constitute an “offer” from mere preliminary negotiations. The Restatement (Second) of Contracts defines an “offer” as:

[T]he manifestation of willingness to enter into a bargain, so made as to justify another person in understanding that his assent to that bargain is invited and will conclude it. 11

“Preliminary negotiations” are defined as:

A manifestation of willingness to enter into a bargain is not an offer if the person to whom it is addressed knows or has reason to know that the person making it does not intend to conclude a bargain until he has made a further manifestation of assent. 12

The lawyer’s role, when they are involved at this stage of the transaction, is to ensure everyone involved “knows or has reason to know” of their contractual status.

10 This has been described as a:

[B]inary characterization, in which an expression either had immediate legal effect, or no legal effect. An offer had the immediate legal effect of creating a power of acceptance in the offeree, and an acceptance had the immediate legal effect of concluding a contract. In contrast, preliminary negotiations had no legal effect.


The easiest way to do this is to employ the sort of language courts will look for while ensuring it objectively conveys the message that is consistent with the client's subjective intent. For example, if the client wants to ensure it is creating no power of acceptance in the other party, consider using the following language to objectively express the client's subjective intent:

PRELIMINARY NEGOTIATIONS ONLY. This correspondence does not create any sort of offer or power of acceptance. Instead, the statements made in this letter merely constitute preliminary negotiations.

2. The Letter of Intent

The letter of intent is often used to memorialize negotiations. The “intent” of the letter is typically to enter into a contract—if the parties can come to an agreement on all the essential terms. The letter of intent states what the parties have tentatively agreed upon, and what remains to be done. However, when it appears the next formal step may not be forthcoming, the party desiring to complete the deal may argue the letter of intent gave rise to contractual obligations. The fundamental issue is what was the “intent” of the parties when entering into their letter of intent. The goal for the drafting attorney is to make the intent clear: Is a present contract intended, with some mere formality to be agreed upon? Or, do the parties intend they will not be bound until, and unless they are able to agree upon some additional form of agreement?

Even when the parties try to express their intent, sometimes it becomes equivocal. For example, in *ACT I, LLC v. Davis*, the parties entered into a “letter of intent” regarding the exploration and development of coalbed methane leases. Davis owned coalbed methane leases and ACT wanted to earn the right to acquire 35% of the Davis working interest in return for arranging financing to develop the leases. After setting out the basic description of the deal, the letter of intent stated:

[T]he parties understand and agree that the transactions contemplated by this letter are non-binding and subject to the following:

(a) Completion of definitive agreements incorporating terms of this letter on or before April 20, 2000 which deadline shall automatically extend for successive 10 day increments until any party gives notice of its intent to terminate this Letter of Intent delivered to all parties at least two (2) business days prior to such termination.

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13I often tell my contracts students to consider the impact of the contract language when it is isolated, placed in a PowerPoint presentation, and projected on the wall for all to see and absorb.

1460 P.3d 145 (Wyo. 2002).

15*Id.* at 147.
The parties entered into an extension agreement on May 4, 2000 which gave ACT until May 20 "to obtain financing arrangements for the Project . . ."16 The extension also stated:

"The parties agree to continue to work together on a best efforts basis to arrange for the completion of the financing upon receipt of an acceptable financing commitment."

"Upon receipt of an acceptable financing commitment, . . . [Davis and ACT] shall enter into definitive agreements to reflect the terms outlined in the Letter of Intent."17

ACT obtained a financing commitment from a lending institution but Davis "decided they did not want to complete the deal and consequently never signed any loan documents."18 Davis contended it was not bound to anything until it signed the financing agreement. Although the trial court held the agreement was unenforceable under the statute of frauds, the Wyoming Supreme Court reverses finding that ACT was seeking to enforce the letter of intent, which was signed by both parties, as opposed to the financing agreement, which was not signed by Davis.19

The court concludes the letter of intent was ambiguous and remands it to the trial court for further proceedings. As the court notes:

Appellees [Davis] contend that they owe no duty to fulfill any of their obligations under the LOI unless and until they formally execute a finalized, written financing agreement. Appellant [ACT] argues that Appellees owed duties under the LOI as soon as they orally expressed agreement to the terms of the proposed financing commitment. At a minimum, Appellant argues, Appellees owed a duty to use their "best efforts" to complete the financing agreement.20

The ambiguity the court alludes to apparently relates to when has an "acceptable financing commitment" been achieved and the ability of either party to terminate on two-days notice between the time the financing commitment is obtained and "definitive agreements incorporating the terms of the Letter of Intent" are finalized. The "best efforts" obligation also runs counter to an ability to refuse to work towards an agreement once a financing package is offered.

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16Id. at 147-48.
17Id. at 148.
18Id.
19Id. at 150.
20Id. at 150-51.
It would seem as though many of these open issues, “omitted terms,” could be filled with an implied obligation of good faith in the performance of the contract. For example, “an acceptable financing commitment” is required to trigger the “best efforts” obligation to work toward the completion of financing. What is “acceptable” must be evaluated in light of the context, purpose, and spirit of the parties’ deal, as articulated by the letter of intent. This means Davis, in exercising its discretion to determine whether the financing commitment is “acceptable,” must exercise its discretion in good faith. The Restatement offers the following guidance on the meaning of “good faith:”

Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party . . . .

Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct is justified . . . . A complete catalogue of types of bad faith is impossible, but the following types are among those that have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party’s performance. This analysis may eliminate the need to harmonize the other provisions, if the trial court finds, as a matter of fact, Davis did not act in good faith when evaluating whether the financing commitment was “acceptable.” The fact the court has to make an inquiry at all demonstrates the inherent risks associated with a letter of intent: it may not give rise to a binding agreement on the object of the transaction, but it may impose intermediate obligations to try and work toward the object, such as a “good faith” evaluation of a financing commitment followed by “best efforts” to complete the financing. Sometimes the parties may be even less specific, but nevertheless contract to “negotiate”

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21 The Restatement, like the Uniform Commercial Code, provides:

Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.

RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981); U.C.C. § 1-203 (1977) (“Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.”). The international counterpart can be found at UNIDROIT, Art. 1.7(1) (“Each party must act in accordance with good faith and fair dealing in international trade.”). INTERNATIONAL INST. FOR THE UNIFICATION OF PRIVATE LAW, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS, Art. 1.7 (1994) [hereinafter UNIDROIT].


in good faith in an effort to arrive at a binding agreement.

3. Intermediate “Contract” to “Negotiate”?

At this stage of the process, it is also prudent to consider the body of case law where courts have found either a contractual obligation to negotiate,24 or have imposed liability on a reliance theory.25 In most instances both parties want to be free of any obligation at the preliminary negotiation phase of a transaction.26 The problem arises with cases such as A/S Apothekernes Laboratorium for Specialskræsler v. I.M.C. Chemical Group, Inc.,27 where the court holds the “letter of intent” signed by the parties did not create a contract for the purchase and sale of assets. However, the letter of intent did give rise to an enforceable contract requiring the parties to negotiate towards arriving at a contract for the purchase and sale of assets. Commenting on the concept of a contract to negotiate, the court states:

The obligation to negotiate in good faith has been generally described as preventing one party from, “Renouncing the deal, abandoning the negotiations, or insisting on conditions that do not conform to the preliminary agreement.” . . . For instance, a party might breach its obligation to bargain in good faith by unreasonably insisting on a condition outside the scope of the parties’ preliminary agreement, especially where such instance is a thinly disguised pretext for scotching the deal because of an unfavorable change in market conditions. . . . The full extent of a party’s duty to negotiate in good faith can only be determined, however, from the terms of the

24E.g., Channel Home Centers v. Grossman, 795 F.2d 291, 300 (3d Cir. 1986) (“the letter of intent and the circumstances surrounding its adoption both support a finding that the parties intended to be bound by an agreement to negotiate in good faith.”).

25E.g., Neiss v. Ehlers, 899 P.2d 700, 707 (Or. 1995) (“promissory estoppel can apply, under appropriate circumstances, to promises that are indefinite or incomplete, including agreements to agree.”).

26This is not to say that often one party will, at some stage of the transaction, find it advantageous to assert that some sort of duty to negotiate exists, or that they have detrimentally relied on the other party’s willingness to try and negotiate the transaction to completion. These are typically after-the-fact revelations which neither party would have argued for going into the transaction because they could not evaluate, at that time, whether they would want to be on the “giving” or “receiving” end of the limitation. Of course, if you know what side of the argument you want to be on going into the transaction, this should be clearly articulated when negotiations begin.

27873 F.2d 155 (7th Cir. 1989).
letter of intent itself.\textsuperscript{28}

The duty to negotiate is better developed under international contract principles. For example, the UNIDROIT Principles of International Commercial Contracts ("UNIDROIT"), provide:

\textbf{ARTICLE 2.15}
\textit{(Negotiations in bad faith)}

(1) A party is free to negotiate and is not liable for failure to reach an agreement.

(2) However, a party who negotiates or breaks off negotiations in bad faith is liable for the losses caused to the other party.

(3) It is bad faith, in particular, for a party to enter into or continue negotiations when intending not to reach an agreement with the other party.\textsuperscript{29}

Similar language is found in the Principles of European Contract Law.\textsuperscript{30}

Although it may not be so clear under international contract principles, under American contract law the parties can avoid any sort of obligation to negotiate by manifesting their intent accordingly. For example, the parties could add the following language to their "preliminary negotiations" section:

\textbf{PRELIMINARY NEGOTIATIONS ONLY.} This correspondence does not create any sort of offer or power of acceptance. Instead, the statements made in this letter merely constitute preliminary negotiations. \textit{Either party can terminate negotiations at any time, for any reason, or no reason, without any obligation to the other party.}

\textbf{4. Liability for Reliance?}

The final lingering risk of pre-contractual liability is that the other party will claim they relied to their detriment on a preliminary understanding or on the fact the parties are engaged in negotiations. Such a claim will be designed to trigger Restatement (Second) of Contracts § 90 which provides, in part:

\begin{center}
\textsuperscript{28}\textit{Id.} at 158.
\end{center}

\begin{center}
\textsuperscript{29}\textit{UNIDROIT, supra} note 21, at Art. 2.15.
\end{center}

\begin{center}
\end{center}
A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires. 31

Liability can arise from a mere “promise” as opposed to a “contract.” To avoid this risk, the drafting goal is to make it clear it would not be reasonable for the other party to act in reliance on negotiations. For example, the parties could add the following language to their “preliminary negotiations” section:

PRELIMINARY NEGOTIATIONS ONLY. This correspondence does not create any sort of offer or power of acceptance. Instead, the statements made in this letter merely constitute preliminary negotiations. Either party can terminate negotiations at any time, for any reason, or no reason, without any obligation to the other party. Any expenditure of money, time, personnel, or other loss of value, associated with conducting negotiations, will be the sole responsibility of the party suffering the expenditure or loss. Under no circumstances will it be reasonable for either party to take any action in reliance on anything said, not said, represented, or otherwise revealed or discussed during these negotiations.

Failing to address these issues can give rise to common problems, as noted in the subsection that follows.

5. The Farmout “Offer” and “Preliminary Negotiations”

The situation addressed by the court in Smith v. Sabine Royalty Corp. 32 illustrates the problems that can be caused, and averted, by routine correspondence regarding one of the most common exploration transactions: the farmout. Sabine owned a 1/6th mineral interest in § 9. 33 El Paso held a lease on the other 5/6ths and entered into a farmout agreement with Buckthal and Franklin obligating them to begin drilling a well on § 9 on or before December 1, 1974. In October 1974 Buckthal and Franklin assigned their rights in the farmout to Smith. Smith then asked Sabine to join him in his drilling venture or lease or farmout its interest to him.” 34 Sabine ultimately responded with the following letter dated November 7, 1974:

In confirmation of our recent telephone discussion and with particular reference to your letter dated October 28, 1974, as I informed you the management of this


33Section 9, Block M-2, H & GN Ry. Co. Survey, Roberts County, Texas. Id. at 366.

34Id. at 367.
Company does not consider the drilling of your proposed test in the captioned section to be in the best interests of Sabine at this time. We strongly prefer that Section 10 be developed before drilling Section 9.

If you elect to proceed with the drilling of the Morror test in Section 9, we would be willing to grant an oil and gas lease to our subsidiary, Dalco Oil Company, with the lease to provide for 1/4 royalty. Dalco would farmout this leased interest to you subject to the drilling of the proposed test with the understanding that production would be required to earn the interest and Dalco would retain a 50% backin option at payout of the well. By the drilling of your initial test and completing a producer, you would be entitled to 100% of this lease insofar as it covers the acreage allocation to the well, or proration unit and you would further be granted a 50% interest in the lease on any acreage outside the initial proration unit. Assuming you complete a gas well and the usual 640 acres plus 10% tolerance is established as field rules in this area you would, in that case, earn all of this leasehold interest in this section through payout. The farmout would be further limited to rights 100' below total depth drilled.

If you wish to pursue this arrangement, please let us know and the appropriate instruments will be forwarded for your approval.

Following this letter the parties did not communicate until January 9, 1975 when Smith telephoned Sabine's representative seeking to "reconfirm" the deal proposed in the November 7 letter. Sabine's representative indicated "management has considered the matter terminated." Smith sent a letter the same day to Sabine indicating he wanted to "accept the proposal" contained in Sabine's November 7 letter. Sabine again responding indicating that "management had already considered negotiations on the matter terminated." As of January 9, 1975, when Smith contacted Sabine, Smith had drilled a producing oil and gas well on § 9 and was aware of its productive capacity.

Smith argued that Sabine's November 7 letter, and Smith's January 9 letter, created a contract. The jury agreed, but the trial court granted Sabine's motion for judgment notwithstanding the verdict. On appeal, the issues focused on the legal effect of Sabine's November 7 letter: was it an offer, or merely preliminary negotiations? Although the court holds the letter was preliminary negotiations and

35 Sabine owned the 1/6th mineral interest in fee so there were no lessor rights to weigh.

36 Smith, 556 S.W.2d at 367.

37 Id.

38 Id. at 367-68.
not an offer, the mere existence of the case, and a jury verdict finding otherwise, demonstrate the need for policing these issues whenever communicating with potential farmees, or more accurately, potential “plaintiffs.”

Whenever faced with language that does not rise to the level of mutual assent, or which does not satisfy the statute of frauds, or when the existence of consideration is at issue, the complaining party will frequently employ a reliance argument which focuses on “the promise,” and their reasonable reliance on the promise, to avoid such contractual defenses. The complaining party is not seeking to enforce a “contract” but rather is seeking equitable relief, in the nature of estoppel, to prevent the other party from denying liability for their actions. This too is illustrated by the Smith case. As the court observes:

Smith . . . testified that he relied on the November 7 letter when he commenced drilling. According to Smith, drilling on the strength of such letters was customary in the business.

Although the court in effect finds, under the facts, that such reliance, if any, was not reasonable in light of the terms of the November 7 letter, other courts have readily embraced a reliance theory when

\[39\] Justifying its conclusion, the court states:

In our opinion, however, the November 7 letter was not an offer which could have been accepted by Smith’s commencement of drilling. The terms of the letter indicated that Sabine and Dalco (Sabine’s wholly owned subsidiary) would be willing to do if Smith elected to drill the well. The language used did not indicate that any offer was being extended at that time. Quite significantly, the terms of the letter invited a response from Smith if he wished to pursue the arrangement. In turn, Sabine would forward the appropriate instruments for Smith’s approval. Nothing in the letter indicated any intent to extend an offer which could be accepted by drilling a well. It is our opinion that the letter was only an invitation to further negotiations.

\[40\] Id. at 368.

\[41\] Id. at 369.

The court notes:

The letter called upon Smith to respond to the proposal outlined; it did not authorize acceptance by performance. The letter, in our opinion, contemplated the making of a bilateral contract which would involve the preparation and approval of formal contract documents.
supported by the facts.

For example, in \textit{Strata Prod. Co. v. Mercury Exploration Co.},\textsuperscript{42} the New Mexico Supreme Court employed a reliance theory to make binding a 120-day option period, and a 30-day extension, to drill under a farmout agreement structured as a unilateral contract. Mercury granted Strata the right to earn interests in Mercury's oil and gas leases if Strata drilled a test well, within 120 days, on the farmout acreage known as the “Lechuza tract,” which was part of Strata's “Red Tank Prospect.” Mercury represented to Strata that it controlled 100% of the working interest in the Lechuza tract that would entitle strata to a 76.5% net revenue interest in the tract.\textsuperscript{43} Strata obtained the farmout from Mercury on August 28, 1991, assigned 98.5% of its rights under the farmout to 24 investors on October 1, 1991, and began drilling on land adjacent to the Lechuza tract on October 29, 1991. On November 10, 1991 Strata's title attorney informed it that Mercury did not own 100% of the leasehold interest nor the represented percentage of net revenue interest. Strata attempted to obtain the missing interests and then, to earn under the Mercury farmout, commenced drilling on the Lechuza tract on January 10, 1992, completing a producing well in February 1992.\textsuperscript{44} Following a trial to the court, the value of this short-fall was set at $616,555.22, which were the damages awarded Strata against Mercury.\textsuperscript{45}

Mercury's defense was that since this was a unilateral contract, and Strata had to drill to earn, Mercury retained the right to revoke its offer anytime prior to Strata's commencement of drilling on the Lechuza tract. Although Mercury had granted Strata a 120-day option period in which to drill the well, plus a 30-day extension, Mercury noted it had received no consideration from Strata to support this option period. Therefore, Mercury could withdraw its offer anytime before Strata began performance, which in this case was after it learned, in November 1991, of the title problem.\textsuperscript{46} Strata, however, was successful in asserting that once it drilled, on October 29, 1991, on the adjacent lands comprising the Red Tank Prospect, it had acted in reliance on the belief it had all the acreage within the Prospect, including the Lechuza tract, under control. Strata's reasonable reliance on Mercury's representations were sufficient to impose liability on Mercury, even though the option “agreement”

\textit{Id.} The court seems to be assuming that if the letter was indeed an offer, as opposed to preliminary negotiations, the only authorized mode of acceptance invited by the offer was by Smith responding to Sabine's “offer,” not the act of drilling a well.

\textsuperscript{42}916 P.2d 822 (N.M. 1996).

\textsuperscript{43}Id. at 825-26.

\textsuperscript{44}Id. at 826.

\textsuperscript{45}Id. at 826-27.

\textsuperscript{46}Id. at 827.
never matured into an option "contract" because it was not supported by consideration.\textsuperscript{47} The court observes:

[T]o invoke the doctrine of promissory estoppel, it is sufficient that the promisee substantially change its position, that this action was foreseen or foreseeable, and that a promise was made which induced the action or forbearance.\textsuperscript{48}

The drafter's goal is to avoid, at the pre-contract stage, making any promise which could justify the promisee in changing their position in reliance on the promise. This will be accomplished by including express language in the negotiations that make it unreasonable for the promisee to assert they could rely on promises or other statements comprising the negotiations.

\textbf{B. Preparation of a More Formal Agreement}

It is common for parties to negotiate a deal and then provide for it to be "formalized" in a written document to be signed by the parties. When a party seeks to walk away from a deal, or seeks new or different terms in trying to agree upon a formal written document, a dispute can arise over whether the parties intended to conclude a contract before, or only upon, agreeing to the written document. Stated another way: was preparation of the subsequent writing an \textit{obligation under an existing contract} or was it intended to be the consummate act of mutual assent when prepared and signed by the parties? The Restatement poses the issue as follows:

Manifestations of assent that are in themselves sufficient to conclude a contract will not be prevented from so operating by the fact that the parties also manifest an intention to prepare and adopt a written memorial thereof; but the circumstances may show that the agreements are preliminary negotiations.\textsuperscript{49}

As with most highly factual inquiries, this one is also readily manageable by the parties—by providing the facts the parties, and judges and juries, will need to answer the basic question: contract or preliminary negotiations? Consider the following approaches to the issue:

\textbf{Present Agreement Intended}

Upon acceptance of this offer, the parties intend to create a presently binding contract which includes the obligation to have this contract memorialized in a formal

\textsuperscript{47}Id. at 828-29.

\textsuperscript{48}Id. at 829.

\textsuperscript{49}Restatement (Second) of Contracts § 27 (1981)
written document acceptable in form to both parties and their legal counsel.\textsuperscript{50}

No Present Agreement Intended

The agreements contained in this letter are merely the parties' preliminary negotiations and no obligations will arise between them until, and unless, they give their mutual assent by signing a formal written farmout agreement to be prepared by the proposed farmor.

The "formal agreement contemplated" problem is an example of a mixed issue of: (1) offer vs. preliminary negotiations; and (2) what must be done to exercise the power of acceptance. The two concepts are closely related but should be addressed separately in any document. This second element of the analysis, "exercising the power of acceptance," is discussed in the next subsection.

C. Effectively Controlling the Exercise of a Power of Acceptance

If the intent is to create a power of acceptance in the other party, the offeror will want to be able to determine, at any time, whether the offer is still in effect and the exact moment it is accepted. This is simple to manage. If you don't, then fairly artificial rules will be applied by courts to resolve the issue.

1. Managing the Offer: Lapse, Revocation, Acceptance

a. Lapse

Uncertainty as to a client's contractual status should be avoided whenever possible. For example, absent a specific time stated in the offer, it will lapse after a "reasonable time."\textsuperscript{51} Recall that

\textsuperscript{50}Aside for the mutual assent issues this language addresses, it should be readily apparent that anytime you seek to agree on something not presently in existence, there is a potential for conflict. These conflicts will be worked out applying a good faith standard to determine whether something is "acceptable in form" in light of the existing contract terms as supplemented by any prior course of dealing and industry custom and usage. The only way to avoid these sticky factual issues is to not agree to be bound until all the details are worked out and reflected in the formal written document. However, the "deal" often proceeds faster that its documentation and the parties may be more concerned with locking-in each other, now, on the basic terms of the deal. The lawyers can work out the "details" later--or so they hope.

\textsuperscript{51}\textsc{Restatement (Second) of Contracts} § 41(1) (1981) ("An offeree's power of acceptance is terminated at the time specified in the offer, or, if no time is specified, at the end of a reasonable time."). As noted in § 41(2) of the Restatement: "What is a reasonable time is a question of fact, depending on all the circumstances existing when the offer and attempted acceptance are made.").
the jury in Smith v. Sabine Royalty Corp.\textsuperscript{52} found that Smith’s January 9, 1975 “acceptance” was “within a reasonable time” from Sabine’s November 7, 1974 letter.\textsuperscript{53} Although the jury was reversed, the fact it took a lawsuit to resolve the issue illustrates why a “reasonable time” should be avoided in most situations. For example, if the intent is to make an offer, but you do not want to have it lasting for an indefinite period of time, the offeror can provide:

This offer lapses on May 31, 2004 at 5:00 p.m. local Topeka, Kansas time.

\textbf{b. Revocation}

However, this language, standing alone, creates another problem: does the offeror intend to create an option contract giving the other party until May 31 to accept, during which time the offeror is unable to revoke its offer? If the subject matter of the contract is a sale of goods, the Uniform Commercial Code permits the creation of a “firm offer” without consideration.\textsuperscript{54} Instead of consideration, the Code requires the offer be made in a signed writing which “by its terms gives assurance that it will be held open . . . .”\textsuperscript{55} The interpretive issue then becomes whether merely specifying a date when the offer will lapse satisfies the “gives assurance that it will be held open.” Although this language would not appear to satisfy the UCC, if the same issue were raised under an international transaction the answer would be different. For example, the United Nations Convention on Contracts for the International Sale of Goods (“CISG”), at Article 16(2), provides an offer cannot be revoked “if it indicates, whether by stating a fixed time for acceptance or otherwise, that it is irrevocable . . . .”\textsuperscript{56} As with the lapse issue, this problem can be easily avoided through drafting:

This offer lapses on May 31, 2004 at 5:00 p.m. local Topeka, Kansas time. \textit{However},

\textsuperscript{52}556 S.W.2d 365 (Tex. Ct. App. 1977).
\textsuperscript{53}Id. at 369.
\textsuperscript{54}U.C.C. § 2-205 (1977) provides:

An offer by a merchant to buy or sell goods in a signed writing which by its terms gives assurance that it will be held open is not revocable, for lack of consideration, during the time stated or if no time is stated for a reasonable time, but in no event may such period of irrevocability exceed three months; but any such term of assurance on a form supplied by the offeree must be separately signed by the offeror.

\textsuperscript{55}Id.

\textsuperscript{56}UNITED NATIONS DIPLOMATIC CONFERENCE, UNITED NATIONS CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS, Art. 16(2) (1980) [hereinafter CISG] (emphasis added).
the offeror can revoke or modify this offer any time prior to its acceptance.

Once it is clear the offeror retains the right to revoke the offer, the next issue is when does the revocation take effect? For example, suppose on May 15, 2004 the offeror mails a letter to the offeree revoking the offer. The letter is received at the offeree’s place of business on May 18, 2004, but the offeree is out of town and does not read the letter until May 21, 2004. When was the revocation effective? May 15, May 18, or May 21? What if the offeree mailed an acceptance on May 15, 2004? On May 17? On May 20? Although there are rules to sort these issues out, the problem can be avoided by providing when a revocation takes effect and when an acceptance takes effect. To fully understand the problem, consider the default rules under the Restatement (Second) of Contracts. First, the Restatement provides:

An offeree’s power of acceptance is terminated when the offeree receives from the offeror a manifestation of an intention not to enter into the proposed contract. 57

Under this rule the revocation is not effective until received by the offeree. 58 Therefore, the risk of transmission is on the offeror. A similar rule is applied under international contracting principles. 59 To shift this risk to the offeree, the offeror can provide:

Any revocation of this offer will be effective when the offeror mails or otherwise dispatches notice the offer is revoked. The revocation will be effective when properly dispatched even though it is not received by the offeree.

c. Acceptance

The act of “acceptance” raises the next major issue. The offeror has it within their power to control what the offeree must do to effectively exercise a power of acceptance. This concept is reflected in Restatement (Second) of Contracts § 30 which provides:


58The Restatement defines “received” as follows:

A written revocation, rejection, or acceptance is received when the writing comes into the possession of the person addressed, or of some person authorized by him to receive it for him, or when it is deposited in some place which he has authorized as the place for this or similar communications to be deposited for him.


59The UNIDROIT principles and the CISG both provide: “Until a contract is concluded an offer may be revoked if the revocation reaches the offeree before it has dispatched an acceptance.” UNIDROIT, supra note 21, at Art. 2.4(1); CISG, supra note 56, at Art. 16(1).
(1) An offer may invite or require acceptance to be made by an affirmative answer in words, or by performing or refraining from performing specified act, or may empower the offeree to make a selection of terms in his acceptance. 60

(2) Unless otherwise indicated by the language or the circumstances, an offer invites acceptance in any manner and by any medium reasonable in the circumstances. 61

Consistent with the other "rules" in this area, the default rule is acceptance in any manner that is "reasonable in the circumstances." However, the offeror is given the power to specify exactly what must be done to accept the offer. Restatement (Second) of Contracts § 60 articulates the principle as follows:

If an offer prescribes the place, time or manner of acceptance its terms in this respect must be complied with in order to create a contract. If an offer merely suggests a permitted place, time or manner or acceptance, another method of acceptance is not precluded. 62

The offeror will want to exercise this power so they know their contractual status at any given time. For example, a default rule most offerors will want to modify is the so-called "mailbox rule" which provides:

Unless the offer provides otherwise,

(a) an acceptance made in a manner and by a medium invited by an offer is operative and completes the manifestation of mutual assent as soon as put out of the offeree’s possession, without regard to whether it ever reaches the offeror; but

(b) an acceptance under an option contract is not operative until received by the offeror. 63

This default rule places the risk of transmission on the offeror. To reverse this risk allocation, the offer can provide:

60 Absent clear direction on the issue, § 32 of the Restatement provides: "In case of doubt an offer is interpreted as inviting the offeree to accept either by promising to perform what the offer requests or by rendering the performance, as the offeree chooses." RESTATEMENT (SECOND) OF CONTRACTS § 32 (1981).


Acceptance of this offer will not be effective until actually received, and brought to the attention of, Larry Landman.

d. Acceptance by Conduct: A Contract Solution to the Tort of Trespass

Tort and contract interface in various ways. For example, an interesting remedy for a continuing trespass may be to turn it into a breach of contract. This was done by the surface owner in *Russell v. Texas Company*, where the oil and gas lessee was unlawfully using the leased land to support oil and gas operations on adjacent lands. When Russell discovered Texas Company was

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64 Many laws define "receive." For example, one of the more intricate definitions is found at § 102 of the Uniform Computer Information Transactions Act which defines "receive" as "to take receipt." § 102(54). "Receipt" is then defined as follows:

"Receipt" means:

(A) with respect to a copy, taking delivery; or

(B) with respect to a notice:

(i) coming to a person’s attention; or

(ii) being delivered to and available at a location or system designated by agreement for that purpose or, in the absence of an agreed location or system:

(I) being delivered at the person’s place of residence, or the person’s place of business through which the contract was made, or at any other place held out by the person as a place for receipt of communications of the kind; or

(II) in the case of an electronic notice, coming into existence in an information processing system or at an address in that system in a form capable of being processed by or perceived from a system of that type by a recipient, if the recipient uses, or other wise has designated or holds out, that place or system for receipt of notice of the kind to be given and the sender does not know that the notice cannot be accessed from that place.

To avoid having to work through this sort of analysis, the parties can simply address the issue in their correspondence.

65 238 F.2d 636 (9th Cir. 1956).
trespassing, Russell sent Texas Company an offer for a revocable license for $150.00 a day. The offer stated: ""[Y]our continued use of the roadway, water and/or minerals will constitute your acceptance of this revocable permit."" Texas Company continued to use the land for 24 days after it received the offer, and then Texas Company notified Russell his offer was rejected. The trial court awarded $3,600 to Russell holding Texas Company had accepted Russell's offer by continuing to use the land after the offer was received. Texas Company argued it had no intent to accept Russell's offer. Applying the Restatement (First) of Contracts § 72(2) the Court of Appeals holds Texas Company's exercise of dominion over the land, after receiving the offer, was conduct manifesting its acceptance of Russell's offer. The ""true test"" according to the court, even if the use was not tortious, is ""whether . . . the offeror was reasonably led to believe that the act of the offeree was an acceptance . . . ."" The test was met in this case.

**e. Notice of Acceptance**

In most instances the parties create a bilateral contract in which notice the offeree is accepting the offer is conveyed immediately to the offeror. In those rare situations where the offeror will not be informed of the other party's acceptance, the Restatement provides:

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66 Id. at 641.

67 The Restatement (First) of Contracts § 72(2) states:

Where the offeree exercises dominion over things which are offered to him, such exercise of dominion in the absence of other circumstances showing a contrary intention is an acceptance. If circumstances indicate that the exercise of dominion is tortious the offeror may at his option treat it as an acceptance, though the offeree manifests an intention not to accept.

The counterpart to this section in the Restatement (Second) of Contracts states:

An offeree who does any act inconsistent with the offeror's ownership of offered property is bound in accordance with the offered terms unless they are manifestly unreasonable. But if the act is wrongful as against the offeror it is an acceptance only if ratified by him.

**Restatement (Second) of Contracts § 69(2) (1981).**

68 238 F.2d at 642.

69 Id. at 643.
Except as stated in § 69\(^{70}\) or where the offer manifests a contrary intention, it is essential to an acceptance by promise either that the offeree exercise reasonable diligence to notify the offeror of acceptance or that the offeror receive the acceptance seasonably.\(^{71}\)

The notice issue arises most often when the offeree is required or authorized to accept by performing an act, but knowledge of the act will not be known by the offeror unless brought to their attention by the offeree. Although the acceptance is effective when the act is performed, a failure to notify the offeror of the acceptance in a timely manner allows the offeror to avoid their contractual obligations. The Restatement rule on this topic provides:

(2) If an offeree who accepts by rendering a performance has reason to know that the offeror has no adequate means of learning of the performance with reasonable promptness and certainty, the contractual duty of the offeror is discharged unless

(a) the offeree exercises reasonable diligence to notify the offeror of acceptance, or

(b) the offeror learns of the performance within a reasonable time, or

(c) the offer indicates that notification of acceptance is not required.\(^{72}\)

These problems can be avoided by simply providing for notification, or no notification, in the correspondence. In many instances the issue will not need to be addressed because compliance with the stated mode of acceptance incorporates an actual notice requirement.

2. Soliciting the Offer: Management Approval Clause

One of the best ways for the offeror to control the situation is to put themself in the position of the offeree while specifying the terms of their own offer. This is typically known as the “home office approval” approach to contracting. Instead of making an offer to the other party, the deal is structured so that when the other party signs the document it becomes their offer for the tendering party’s acceptance or rejection. However, as with any situation where the final manifestation of assent

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\(^{70}\)Section 69 addresses the exceptional situations when a failure to speak—silence—will be an acceptance. The basic rule is that an offeree’s failure to respond to an offer is not an acceptance. The exceptions include situations such as an express agreement of the parties on the matter, or prior dealings that give rise to a duty to speak. \textit{Restatement (Second) of Contracts} § 69 (1981).

\(^{71}\)\textit{Restatement (Second) of Contracts} § 56 (1981).

\(^{72}\)\textit{Restatement (Second) of Contracts} § 54 (1981).
is delayed, either party is free to walk away from the proposed deal. But in most instances, the management approval clause is desired to control the process and absolutely necessary when conducting negotiations through employees or agents who are not authorized to make the deal.

The specific action that "management" must take to effect an approval, and therefore an acceptance, must be carefully defined. If it is not, the "approval" may take place at some undesired time prior to the act of the appropriate manager signing on the dotted line. This was a $1.45 million problem for a gas purchaser in Manchester Pipeline Corp. v. Peoples Natural Gas Co.73 where Peoples sent copies of an unsigned Gas Purchase Contract to Manchester with a letter stating:

"Enclosed for your review and approval, please find three copies of our Gas Purchase Contract covering acreage referenced above.

"If you find this Contract acceptable, please fully execute all three copies, (including notary pages) and return to this office. Following [PNG’s] execution, one completed Contract will be forwarded to you."74

This letter was sent on September 12, 1984, the contracts were executed by Manchester and returned on September 18, 1984, but "PNG never executed the copies and denies that a contract for the purchase of gas has even been formed between the parties."75 The gas market was rapidly deteriorating in the Fall of 1984 and PNG decided it really didn’t want to enter into the 10-year take-or-pay contract it had been negotiating with Manchester since November 1983.

Peoples argued the contract signed by Manchester was merely an offer which was not accepted by Peoples because it never signed it. In a letter dated October 29, 1984 Peoples informed Manchester "there would be no binding contract until PNG’s management signed and executed the Document, and advising Manchester not to proceed with installation of the pipeline until PNG’s management had done so."76 However, when the jury considered the issue, it accepted Manchester’s argument that when People’s sent the three copies of the contract for Manchester’s execution, that was an offer by People’s which was accepted by Manchester when it signed and returned the documents. The factual issue was whether Manchester had "reason to know" that Peoples did not intend to create a power of acceptance in Manchester, but rather sought to solicit an offer which could only be accepted by the

73 862 F.2d 1439 (10th Cir. 1988).

74 Id. at 1441.

75 Id.

76 Id. at 1442. Of course this letter would have no effect if an offer existed that was accepted by Manchester in September.
formal act of Peoples’ management signing the documents. It would have been easy to control what Manchester had “reason to know” in the correspondence leading up to sending the three copies of the contract. For example, consider the following:

By signing the three copies of the enclosed Gas Purchase Agreement, you are making an offer to Peoples for consideration by its senior management. Until and unless approved by Peoples’ management, and the Gas Purchase Agreement is signed by Peoples’ Vice President for Gas Acquisition, this offer will not become a contract.

3. Managing the Acceptance: Rejection, Counter-Offer

a. Rejection

A person’s power of acceptance is extinguished once they reject the offer. The Restatement provides:

(1) An offeree’s power of acceptance is terminated by his rejection of the offer, unless the offeror has manifested a contrary intention.

(2) A manifestation of intention not to accept an offer is a rejection unless the offeree manifests an intention to take it under further advisement.

Often it is difficult to determine the status of a rejection because the offeror, upon receiving the rejection, may actually renew the offer by saying, for example: “just think about it a while and let me know.” It is also possible for the offeree to open up a parallel line of negotiation without rejecting the offer that is on the table. For example, the offeree might say: “Without addressing your offer, and keeping it under further advisement, I would like to see if your would take $10,000 in cash to right now to close the deal.”

When a rejection is intended by the offeree, the rejection will take effect, under the

77Id. at 1445.

78However, if the offer is made as an option contract, the Restatement (Second) of Contracts provides: “the power of acceptance under an option contract is not terminated by rejection or counter-offer, by revocation, or by death or incapacity of the offeror, unless the requirements are met for the discharge of a contractual duty.” RESTATEMENT (SECOND) OF CONTRACTS § 37 (1981) (emphasis added). Although the power of acceptance is not terminated, there could be instances where the party upon being informed of the rejection may take action in reasonable reliance on the representation.

Restatement rule, only upon receipt by the offeror. Restatement § 40 provides:

Rejection or counter-offer by mail or telegram does not terminate the power of acceptance until received by the offeror, but limits the power so that a letter or telegram of acceptance started after the sending of an otherwise effective rejection or counter-offer is only a counter-offer unless the acceptance is received by the offeror before he receives the rejection or counter-offer.


199 P.2d 1006 (Colo. 1948).

Id. at 1009-10.

24
to reject the offeror's pending offer. For example, in comment b. it is provided:

A mere inquiry regarding the possibility of different terms, a request for a better offer, or a comment upon the terms of the offer, is ordinarily not a counter-offer. Such responses to an offer may be too tentative or indefinite to be offers of any kind; or they may deal with new matters rather than a substitution for the original offer; or their language may manifest an intention to keep the original offer under consideration.84

D. Consideration Issues

The Restatement (Second) of Contracts continues the basic bargain theory of consideration, by providing, in part:

(1) To constitute consideration, a performance or a return performance must be bargained for.

(2) A performance or return promise is bargained for if it is sought by the promisor in exchange for his promise and is given by the promisee in exchange for that promise.

(3) The performance may consist of

(a) an act other than a promise, or

(b) a forbearance, or

(c) the creation, modification, or destruction of a legal relation.85

In the exploration arena, consideration issues arise in two general situations: (1) the illusory agreement where one party is obligated to do something and the other party has not limited their freedom to act in any real manner; and (2) modifications to an existing contract.

1. I Want Them Bound, But I Don’t Want To Be Bound

Many clients often seek ways to keep the other party on the hook while they retain unfettered freedom whether to perform an agreement. The problem is that when it matters, if the client is not bound, neither is the other party. Instead of going through the tortured process of trying to manufacture an obligation when none exists, clients should consider the device designed to allow them to think it over while the other party is locked into an offer: the option contract. It is probably one

84Id. at comment b.

of the more under-used devices to commit a party to an offer while the other party considers its options. Most courts, and the Restatement (Second) of Contracts, even apply a less rigorous consideration requirement for option contracts.86 The Uniform Commercial Code recognizes a merchant's "firm offer" without consideration,87 and in the international arena the consideration requirement to hold open an offer has been eliminated entirely.88

2. Modification

At common law the agreement to forego a contractual right required consideration to be enforceable. For example, assume a party to a farmout agreed to test a formation in order to earn rights in the formation. The farmee asks their farmor if they can be relieved of the testing requirement on specified formations, but nevertheless still earn rights in the formation. The farmor agrees, but changes his mind before the farmee has detrimentally relied on the agreement. The farmor is not bound by its modification agreement because it was not supported by consideration. Although the farmor agreed to give up its contractual right to insist that the farmee test-to-earn rights in a formation, the farmee gave up nothing in return.

Although most states still require consideration to support a modification, the Restatement (Second) of Contracts has eliminated the requirement by providing:

A promise modifying a duty under a contract not fully performed on either side is binding

86RESTATEMENT (SECOND) OF CONTRACTS § 87 (1981) ("An offer is binding as an option contract if it . . . is in writing and signed by the offeror, recites a purported consideration for the making of the offer, and proposes an exchange on fair terms within a reasonable time . . . .") (emphasis added).

87U.C.C. § 2-205 (1977) provides:

An offer by a merchant to buy or sell goods in a signed writing which by its terms gives assurance that it will be held open is not revocable, for lack of consideration, during the time stated or if no time is stated for a reasonable time, but in no event may such period of irrevocability exceed three months; but any term of assurance on a form supplied by the offeree must be separately signed by the offeror.

Emphasis added.

88The CISG provides "an offer cannot be revoked . . . if it indicates, whether by stating a fixed time for acceptance or otherwise, that it is irrevocable . . . ." CISG, supra note 56, Art. 16(2)(a).
(a) if the modification is fair and equitable in view of circumstances not anticipated by the parties when the contract was made; or

(b) to the extent provided by statute; or

(c) to the extent that justice requires enforcement in view of material change of position in reliance on the promise. 89

If the contract concerns a sale of goods, Uniform Commercial Code § 2-209 provides: "An agreement modifying a contract within this Article needs no consideration to be binding."90 However, the comment to this section states it applies only to a modification made in "good faith."91 Presumably if the modification were made as a forced concession, it would not be enforceable unless actually supported by consideration. The CISG follows the UCC's approach in § 2-209.92

At common law, parties to a written agreement can modify it orally, even though it contains a "no oral modification" clause. For example, in Ruby Drilling Co. v. Duncan Oil Co., Inc.,93 the drilling contract stated: "Any alternation or deviation from above specifications involving extra costs, will be executed only upon written orders . . . ."94 The driller argued the "footage" drilling contract was modified by the parties into a "daywork" contract when the hole began to substantially deviate from the vertical. The court first states the basic rule regarding oral modifications:

[Parties to a written agreement may orally waive or modify their rights under the agreement. We have further indicated that an oral modification of a written agreement may be possible even when the agreement contains a no-unwritten-modification clause. The party asserting that a written agreement was modified by the subsequent expressions or conduct of the parties must prove so by clear and convincing evidence.]95

In this case the court finds the evidence of an oral modification clearly unconvincing and enforces the


91Id. at cmt. 2.

92CISG, supra note 56, Art. 29(1) ("A contract may be modified or terminated by the mere agreement of the parties.").

9347 P.3d 964 (Wyo. 2002).

94Id. at 967.

95Id. at 968.
written footage drilling contract. 96

If the agreement concerns a sale of goods, the no oral modification clause is elevated to a private statute of frauds. As noted previously, U.C.C. § 2-209(1) has substituted a signed writing for consideration to validate contract modifications not supported by consideration. To further support this "form" substitute for consideration, U.C.C. §2-209(2) states, in part: "A signed agreement which excludes modification or rescission except by a signed writing cannot be otherwise modified or rescinded ...."97 However, the balance of § 2-209 mitigates even this requirement by recognizing the requirement can be "waived" or the party can seek relief due to their reasonable reliance on the oral modification. 98 Even though a party is able to overcome the consideration and no oral modification private statute of frauds, the contract, as modified, must still satisfy any statutory or common law statute of frauds. 99

E. Statute of Frauds

Because most oil and gas exploration agreements impact real property in some way, they are generally subject to the equivalent of Section 4 of the original English Statute of Frauds of 1677 which provided, in part:

And be it further enacted ... that ... no action shall be brought

... (4) upon any contract or sale of lands, tenements or hereditaments, or any interest in or concerning them ...

unless the agreement upon which such action shall be brought, or some memorandun or note thereof, shall be in writing, and signed by the party to be charged therewith, or some other person thereunto by him lawfully authorized.

Parties may engage in negotiations and at some point, prior to the preparation of a final written document, a party will break off negotiations. This will often prompt one of the parties to assert a contract has already been formed. The focus will then shift to whether any writing exists, of the alleged agreement, that satisfies the statute of frauds. For example in EP Operating Co. v. MJC

96 Id. at 969.

97 U.C.C. § 2-209(2) (1977). The international counterpart to the U.C.C. has a similar provision. CISG, supra note 56, Art. 29(2).


99 Id. at § (3).
Energy Co.,\(^{100}\) one party sought to rely on a series of letters to satisfy the statute of frauds. However, none of the letters contained language indicating an acceptance of the offer, but rather continued the negotiations toward a possible agreement.\(^{101}\)

As the court explains:

The statute of frauds requires the written agreement or memorandum to be complete within itself in every material detail and to contain all of the essential elements of the agreement so that the contract can be ascertained from the writings without resort to oral testimony.  

For example, a signed writing agreeing to enter into “an 88 form lease” on specifically described land was not enforceable, under the statute of frauds, because the terms of the required lease could not be ascertained from the writing.\(^{103}\) The other context in which the statute of frauds frequently is an issue concerns property descriptions. For example, in Westland Oil Development Corp. v. Gulf Oil Corp.,\(^ {104}\) the court considers whether the impacted land in an area of mutual interest clause was sufficiently identified to satisfy the statute of frauds. The area of mutual interest was described as follows:

If any of the parties hereto, their representatives or assigns, acquire any additional leasehold interests affecting any of the lands covered by said farmout agreement, or any additional interest from Mobil Oil Corporation under lands in the area of the farmout acreage, such shall be subject to the terms and provisions of this agreement . . . \(^{105}\)

The court held the portion of the AMI described as “lands covered by said farmout agreement” were adequately described while “lands in the area of the farmout acreage” were not adequately described. In this case the “farmout agreement” contained a detailed description of the lands it covered, but there was not any way of defining the extent of land in the “area of the farmout acreage.”\(^{106}\)

\(^{100}\)883 S.W.2d 263 (Tex. Ct. App. 1994).

\(^{101}\)Id. at 267.

\(^{102}\)Id.

\(^{103}\)Fagg v. Texas Co., 57 S.W.2d 87, 89 (Tex. Comm'n App. 1933).

\(^{104}\)637 S.W.2d 903 (Tex. 1982).

\(^{105}\)Id. at 905.

\(^{106}\)Id. at 906.
III. SURVEY OF COMMON EXPLORATION CONTRACT PROBLEMS

A. Too Few Contractual Agreements

Often a simple agreement can avoid all sorts of problems, particularly when dealing with sensitive pre-exploration information. Although Lynn Hendrix will be addressing confidentiality and nondisclosure agreements, in this section I want to consider the $4 million "waiver agreement." Suppose a geologist generates an idea, a theory about the location of new, yet-to-be discovered oil and gas deposits. He approaches an oil company already very active in the area and makes a presentation in which he shares his theories and seeks to sell his "prospect" to the company. The company’s exploration manager and the geologist share information but the manager does not agree with the geologist’s interpretation, and tells the geologist the company is not interested in his prospect. Four months later the state offers several tracts of land for lease, some of which are within the prospect area the geologist discussed. The company acquires leases, in the state lease sale and within the prospect area, for $540,000. The geologist sues asserting the company breached a confidential relationship with the geologist pleading theories in negligence, gross negligence, fraud, and misappropriation of a trade secret. The jury finds for the geologist and awards $1,430,000 in actual damages and $2,600,000 in punitive damages. During the litigation the company let the leases it acquired for $540,000 expire because it did not want to drill while this dispute was pending. This would be the end of the story, if there had been no agreement between the parties.

The facts are taken from Unocal Corp. v. Dickinson Resources, Inc.,107 in which, but for a "waiver agreement," the jury’s verdict may have been upheld.108 However, the Court of Appeals reverses relying upon a letter which the company required the geologist to sign before the company would listen to the geologist’s presentation, or look at his data. The letter stated:

This letter is written in connection with the review by Union . . . of certain geologic and/or geophysical data and/or land and leasehold information provided by your company.

You agree to waive any claim demand or cause of action, either legal or equitable, which may be asserted against . . . Union concerning use of any data or information of a proprietary or confidential nature which is provided for review by .


108 Unocal argued it did not rely upon the geologist’s theories or information but instead acquired the leases based upon a study it had commenced two years prior to the meeting, and had only recently completed. It also acquired new seismic data on the area prior to the lease sale. Perhaps most notable, Unocal had up to 300 producing wells, and had drilled 800 wells, in the general area. Id. at 606-07. The jury apparently was not impressed.
The court reverses and enters judgment for Unocal Corp. holding the waiver barred all of the geologist’s claims. Commenting on the wisdom of such agreements, the court observes:

From Unocal’s perspective, it is easy to see why it required the waiver form. It sought to prevent exactly what occurred in this case: a claim that it “stole” an idea, prospect, data or information, whatever it is called. Without such agreements, an exploration company such as Unocal would never meet with a vendor such as DRI because of the risk of claims like the kind DRI has made here.

B. Too Many Contractual Agreements

Freedom of contract includes the freedom to enter into numerous contracts with numerous parties. Therefore, a developer can enter into development or operating agreements with several working interest owners as a group in a single contract, or individually or in sub-groups in multiple contracts. It is not surprising that various working interest owners may drive a different bargain for themselves. The developer’s problem is ensuring it can comply simultaneously with all of its contractual obligations. Absent express language in the agreements, one party’s agreement with the developer will not be limited by the terms the developer has with other parties. Frequently this express language is simply that the current agreement being entered into with a party is “subject to” another adequately described agreement.

For example, in Westland Oil Development Corp. v. Gulf Oil Corp., the initial exploration program began with an August 4, 1966 “farmout agreement” between Mobil Oil Corporation and

\[109\text{Id. at 607.}\]

\[110\text{The court states:}\]

We conclude the waiver is binding and bars all of DRI’s [the geologist’s] claims. The waiver specifically provided that review of DRI’s data did not preclude any oil and gas operation or activity in any area. This language is clear. The waiver extinguished DRI’s right to sue Unocal as effectively as a prior judgement between the parties.

\[111\text{Id. at 610.}\]

\[112637\text{ S.W.2d 903 (Tex. 1982).}\]
Westland where Mobil agreed to farm out leased acreage to Westland. Westland then entered into a November 15, 1966 “letter agreement” with C & K in which C & K assumed Westland’s duties under the farmout agreement, compensated Westland for assigning its rights in the farmout agreement, and created an area of mutual interest in which Westland would have rights in certain future acquisitions by C & K. C & K entered into agreements with several investors and then drilled the required well and earned rights in the Mobil farmout acreage. On March 7, 1968 Mobil conveyed the earned acreage to C & K and its investors by an assignment containing the following language:

This Assignment is made without warranty to title, either express or implied. In addition, as to all the lands and depths herein assigned (except as to said Section 18) this Assignment shall be subject to all the provisions of that certain Operating Agreement dated March 1, 1968, by and between Assignor and Assignee.

The provisions hereof shall be binding upon, and shall inure to the benefit of, the parties hereto and their respective heirs devisees, legal representatives, successors and assigns.

In paragraph 31 of the referenced Operating Agreement, the following references were made to a “Farmout Letter Agreement” and “Letter Agreement”:


Such interests [of each Assignee] are specifically subject to all terms, conditions and reservations set forth in that Farmout Letter Agreement dated August 4, 1966 between Mobil Oil Corporation and Westland Development Corporation, as amended, and that certain Assignment dated March 7, 1968 from Mobil Oil Corporation to C. Fred Chambers and W. D. Kennedy and Union Texas Petroleum.

On April 18, 1972 Mobil entered into a farmout agreement with Hanson which Hanson assigned to Gulf and Superior. Hanson also obtained farmouts from C & K, Union Texas, and their other associates. These farmout agreements were also assigned to Gulf and Superior which drilled

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113 Id. at 905-906.
114 Id. at 906.
115 Id. (bold emphasis added).
a successful test well and received assignments that were "subject to" the March 1, 1968 Operating Agreement. The dispute in this case arose when Westland came forward and claimed rights to the acreage farmed-out to Gulf and Superior relying upon the November 15, 1966 letter agreement's area of mutual interest provisions. The court holds that Gulf and Superior took their interest "subject to" each agreement, or burden, that can be reasonably identified by "every recital, reference and reservation contained in or fairly disclosed by any instrument which forms an essential link in the chain of title under which he claims." In this case, the only document of record was the assignment, but the assignment referred to an unrecorded operating agreement. This imposed an obligation on the assignee to try and procure a copy of the operating agreement. Investigation of the operating agreement revealed references to letter agreements regarding the farmout transactions. This also imposed an obligation on the assignee to procure a copy of these documents and determine their effect on its interest. Had the assignee done this, they would have been alerted to Westland's area of mutual interest rights in the assigned property. Therefore, the interests assigned to Gulf and Superior are subject to Westland's rights created by the twice removed unrecorded letter agreements.

The point of this discussion is that often there will be multiple contracts impacting an exploration deal; all of them must be accounted for and a mere reference to them in a document within the chain of title will create an obligation to track down each document, read it carefully, and ascertain its total effect on the rights at issue. Sometimes it will be nearly impossible to reconcile all the agreements to define the parties rights. This is a particular problem when an area is experiencing intense competitive exploration and there are several groups forming areas of mutual interest that bind successors and assigns. What happens when a participant in one group acquires interests in another group? How are conflicting AMI obligations to be resolved? The answer is clear: they will be resolved either by agreement or by litigation—because the existence of separate conflicting contractual obligations will not, absent express provisions in one or both of the contracts, limit the effect of any of the contracts at issue.

This concept is perhaps best illustrated by the situation where a gas producer has multiple, independent gas sales contracts with a purchaser. Just because a purchaser breaches its obligations under Contract "A" does not mean the producer can in any way impair the purchaser's rights under Contract "B." Unless there is express contract language allowing for an offset associated with Contract B, any failure by the producer to honor Contract B will be a breach of Contract B, regardless of what the purchaser has done under Contract A. The two contracts exist as separate legal obligations, and must be dealt with as separate legal obligations, even when the parties are the same. In most exploration agreements the principle is even more pronounced because there will often be a

116 *Id.* at 907.

117 *Id.* at 908.

different mix of parties to the contracts. It is also likely that exploration agreements will be more "customized" and therefore presenting their own unique issues concerning what constitutes the contract "terms," and what they "mean."

C. What Is the Contract? What Does it Mean?

Although exploration seems to generate a large number of contract formation issues, it also generates a substantial number of interpretive issues. Contract interpretation is perhaps one of the most confusing areas of the law—or at least the most difficult to try and reconcile the case law. I believe most of the confusion is caused by courts picking-and-choosing, and manipulating, "rules" used to interpret contracts. For example, most jurisdictions have an irreconcilable collection of cases addressing when and to what extrinsic evidence can be used to determine the "meaning" of a contract. Typically the ambiguous threshold of "ambiguity" is employed to marshal the evidence with the court as the arbiter of what is, and is not, ambiguous—and therefore what will, and will not, be considered in ascertaining the intent of the parties. If the process becomes too transparent, the court can drag out the parol evidence rule to further confuse the situation. Equity is alive and well in contract interpretation.

When approaching an interpretation problem, consider the following organizing principles: First, the parol evidence rule should be used only to determine the universe of terms that comprise the contract. The parol evidence rule does not deal with what the terms mean; it just identifies the terms that are available for interpretation. The parol evidence rule seeks to give effect to any final written agreement the parties intend to adopt as either their partial or complete integrated agreement. This issue frequently arises in oil and gas cases where it may be expressed in terms of "merger." For example, in *Avien Corp. v. First National Oil, Inc.*, the court had to consider whether limiting language in a farmout agreement the parties intend to adopt as either their partial or complete integrated agreement. This issue frequently arises in oil and gas cases where it may be expressed in terms of "merger." For example, in *Avien Corp. v. First National Oil, Inc.*, the court had to consider whether limiting language in a farmout agreement the parties intend to adopt as either their partial or complete integrated agreement. The court correctly noted "the merger doctrine is based on the intention of the parties" and "[i]ntent is a question of fact to be determined from the written instrument as well as the facts and circumstances surrounding its execution." In the *Avien* case the terms of the "written instrument," the assignment, were particularly helpful because, as the court noted: "The assignment document was expressly made subject to the farmout agreement." However, even absent this express language,

119 This topic is discussed extensively, with oil and gas law examples, in: David E. Pierce, *Defining the Role of Industry Custom and Usage in Oil & Gas Litigation*, 57 SMUL. REV. Issue 2 (expected publication date, Summer 2004).


121 *Id.* at 227 (emphasis added).

122 *Id.* The court uses this language to arrive at the following conclusion:

The purpose of making a document subject to another document is to keep the
the court should be willing to consider extrinsic evidence to ascertain the parties’ intent regarding merger.\textsuperscript{123}

Once the terms of the contract are identified, the second step is to ascertain their meaning. This is where courts continue to suffer from the assumption that a judge can simply look at a word on paper and determine what it means—unless it is ambiguous—in which case they can consider extrinsic evidence to aid their interpretation. The Restatement (Second) of Contracts adopts the more realistic view of Professor Corbin on this subject, by providing:

Agreements and negotiations prior to or contemporaneous with the adoption of a writing are admissible in evidence to establish

(a) that the writing is or is not an integrated agreement;

(b) that the integrated agreement, if any, is completely or partially integrated;

(c) the meaning of the writing, whether or not integrated;

(d) illegality, fraud, duress, mistake, lack of consideration, or other invalidating cause;

(e) ground for granting or denying rescission, reformation, specific performance, or other remedy.\textsuperscript{124}

When the purpose of interpretation is properly identified—ascertaining the intent of the parties—courts should be able to consider any relevant evidence bearing on the question.\textsuperscript{125}

first document controlling over the second document. Using a plain meaning analysis, it is clear that the parties did not intend the farmout agreement to be merged with the assignment.

\textit{Id.}

\textsuperscript{123}“Merger” is the property law context of the parol evidence rule. Finding that the terms of a contract have merged into a conveyance is similar to the contract context of concluding the parties intended the final writing to be a completely integrated statement of their agreement.

\textsuperscript{124}\textsc{Restatement (Second) of Contracts} § 214 (1981).

\textsuperscript{125}See generally David E. Pierce, \textit{Defining the Role of Industry Custom and Usage in Oil \& Gas Litigation}, 57 SMU L. REV. Issue 2 (expected publication date, Summer 2004).
BASIC CONTRACT
PRINCIPLES IMPACTING
EXPLORATION PROJECTS
David E. Pierce
Professor of Law
Washburn University School of Law

I. INTRODUCTION
• "Exploration—the investigation of unknown regions."
• Managing the "unknown" through contract.
• Private ordering.
• Freedom of contract.
• Exploration Agreements: give-and-take among sophisticated parties.
• Unique and complex.

II. CONTRACT FORMATION
• Easy to create a contract.
• Objective theory of contracts.
• Freedom of contract creates burdens and opportunities.
• Control the contract formation process through drafting.

II. CONTRACT FORMATION
• Until there is a power of acceptance that has been exercised, the parties are engaged in preliminary negotiations.
• If at the preliminary negotiation stage, either party generally has the ability to walk away from the deal without liability.

II. CONTRACT FORMATION
• The Basic Task/Goal: Be able to identify the parties' contractual status at all times.
• Preliminary Negotiations?
• Has a power of acceptance been created?
  - Is there an "offer" pending?
• Has a power of acceptance been exercised?
  - Has an offer been "accepted?"

A. Controlling the Creation of a Power of Acceptance
PRELIMINARY NEGOTIATIONS ONLY. This correspondence does not create any sort of offer or power of acceptance. Instead, the statements made in this letter merely constitute preliminary negotiations.
A. Controlling the Creation of a Power of Acceptance

- The Letter of Intent
- The "intent" of the letter is typically to enter into a contract—if the parties can come to an agreement on all the essential terms.
- States what the parties have tentatively agreed upon, and what remains to be agreed upon.
- Can contain language indicating a present contract is intended, or perhaps an interim contract to "negotiate," or no contract.

A. Controlling the Creation of a Power of Acceptance

- Upon receipt of an acceptable financing commitment, . . . [Davis and ACT] shall enter into definitive agreements to reflect the terms outlined in the Letter of Intent.

Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.

Restatement (2d) of Contracts § 205.

A. Controlling the Creation of a Power of Acceptance

- "The parties understand an agree that the transactions contemplated by this letter are non-binding and subject to the following . . . ."
- "The parties agree to continue to work together on a best efforts basis to arrange for the completion of the financing . . . ."

A. Controlling the Creation of a Power of Acceptance

- Have the parties entered into a contract to negotiate to try and arrive at a deal on the matter that brought them together?

A. Controlling the Creation of a Power of Acceptance

- Reliance claims: I relied to my detriment on your representations during our preliminary negotiations; my reliance was foreseeable and reasonable so pay me damages.
- Consider Restatement (2d) of Contracts §90:
A. Controlling the Creation of a Power of Acceptance

  • When did the farmout offer lapse?
  • Was it an offer?
  • What did it require for acceptance?
  • Reliance on the letter?

B. Preparation of a More Formal Agreement?

• Formal Agreement Contemplated?
  • Was preparation of the subsequent writing an obligation under an existing contract or was it intended to be the consummate act of mutual assent when prepared and signed by the parties?

C. Effectively Controlling the Exercise of a Power of Acceptance

• Managing the Offer:
  • Lapse: How long will it last?
  • Reasonable Time vs. Specified Time
  • Revocation: Any limitations on offeror's ability to revoke the offer?
  • When does the revocation take effect?

C. Effectively Controlling the Exercise of a Power of Acceptance

This offer lapses on May 31, 2004 at 5:00 p.m. local Topeka, Kansas time. However, Pierce can revoke or modify this offer any time prior to its acceptance. Any revocation of this offer will be effective when Pierce mails or otherwise dispatches notice the offer is revoked. The revocation will be effective when properly dispatched even though it is not received by Acme.
C. Effectively Controlling the Exercise of a Power of Acceptance

- **Acceptance**: The offeror can prescribe exactly what must be done to accept the offer.
- Alter the mailbox rule to make it effective only if received by the offeror.

C. Effectively Controlling the Exercise of a Power of Acceptance

- **Rejection**: Is it a rejection that terminates the power of acceptance, or merely an inquiry that keeps the offer open while a parallel series of negotiations are pursued?
- Did the offeror renew the offer after the rejection? "Think it over."

C. Effectively Controlling the Exercise of a Power of Acceptance

- Soliciting the Offer: Management Approval Clause.
- Nail down the specific moment when an offer becomes a contract.
  - Sending the unsigned contracts to the producer was the "offer" and the producer signing them was the acceptance.

C. Effectively Controlling the Exercise of a Power of Acceptance

- **Counter-Offer**: Parallel negotiation or a direct response to the offer?
  - So close, but so far.

D. Consideration

- Clients desire to bind the other party without being bound themselves.
- Illusory promise; neither party is bound.
- **Option contract**: pay for a subsidiary contract to keep an offer open for a stated period of time.
- U.C.C. § 2-205 Firm Offer.
- CISG Art. 16(a)(a).

D. Consideration

- Modification: one party agrees to relieve the other party of a duty.
- Waiver.
- Reliance.
- U.C.C. § 2-209.
E. Statute of Frauds

No action shall be brought... upon any contract or sale of lands, tenements or hereditaments, or any interest in or concerning them... unless the agreement upon which such action shall be brought, or some memorandum or note thereof, shall be in writing, and signed by the party to be charged therewith, or some other person thereunto by him lawfully authorized.

E. Statute of Frauds

• Documents signed that reflect an agreement but too indefinite to enforce. Fagg v. Texas Co., Paper at Page 29.
• No signed document sufficient to bind the targeted party.

E. Statute of Frauds

• Westland Oil Development Co. v. Gulf Oil Corp., Paper at Page 29. The AMI:
  • “If any of the parties hereto... acquire any additional leasehold interests affecting any of the lands covered by said farmout agreement, or any additional interest from Mobil Oil Corporation under lands in the area of the farmout acreage, such shall be subject to the terms and provisions of this agreement.”

III. SURVEY OF CONTRACT ISSUES

• Too Few Contractual Arrangements
  • Allowing yourself to see and hear another person’s presentation of a prospect.
  • The $4 Million “Waiver Agreement”
  • Jury verdict on claims of negligence, gross negligence, fraud, and misappropriation of trade secrets.

III. SURVEY OF CONTRACT ISSUES

• Too Many Contractual Agreements
  • The problem of multiple contracts with different parties creating conflicting contractual obligations.

III. SURVEY OF CONTRACT ISSUES

• $1.4 Million in Actual Damages—there might be oil out there.
• $2.6 Million in Punitive Damages.
• Successful bidder (no other bidders) on state leases. Unocal very active in area.
• Reversed by Court of Appeals.
• Signing letter waived any right to a claim for use of the information.
III. SURVEY OF CONTRACT ISSUES

- Contracts are contracts.
- Unless tied by their terms, they must be complied with fully, even though it may create conflicting obligations.
- "Subject to" language.
- Classic example: breach of contract A will not create special rights in contract B, unless they are tied together by express contract language.

III. SURVEY OF CONTRACT ISSUES

- What is the Contract?
- Parol Evidence Rule used to identify the contract terms.
- Interpretation Rules used to determine what the contract terms mean.
- Tortured Jurisprudence: can anyone look at a word on paper and know what it means without considering extrinsic evidence? Professor Corbin: No.

III. SURVEY OF CONTRACT ISSUES

- Exploration agreements present some of the most challenging interpretation issues because they are typically custom-made for each transaction, negotiated between sophisticated parties to leverage unknown risks, for an expensive high risk undertaking. To add to the complexity there are often multiple parties, with varying interests, participating pursuant to differing layers of contractual agreements.